TESTIMONY OF THE HONOURABLE PETER SKINNER MEP

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SUBCOMMITTEE ON CAPITAL MARKETS

HEARING ON
"SYSTEMIC RISK AND INSURANCE"

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Introduction

Thank you Chairman Kanjorski, Congressman Garrett, and Honorable Members of this Subcommittee for inviting me to attend and give evidence today on this important issue.

I am Peter Skinner. I have been a Member of the European Parliament since 1994. I represent the South East of England Region with a population of over six million Britons. This month I was reelected to a fourth term in the European Parliament.

I have been a Member of the Economic and Monetary Affairs Committee for 13 years and am the European Parliamentary Labour Party's spokesperson on Financial and Economic Affairs.

I chair EPIC, the European Parliamentary Insurance Caucus, and also am the Chair of the European Parliamentary Financial Services Forum. I also take a leading role on issues relating to EU/USA economic cooperation. I have been Transatlantic Economic Council (TEC) Advisor for the European Parliament as part of the Transatlantic Legislators Dialogue, and have been a senior member of the EU Parliament's USA delegation for a decade.

I am the Rapporteur - sponsor of the bill - of the Reinsurance Directive (2005) and most recently, the Solvency II insurance legislation in the European Parliament. This new Solvency II legislation has been passed recently in the European Union and will become law across 27 member countries in 2012. The approach taken for the agreement of such a law was based on a series of Quantitative Impact Assessments, the results of which have been broadly the same across Europe. The Committee of European Insurance and Pension Supervisors (CEIOPS) – an organization of insurance regulators in EU member states - has worked closely with European Parliament and EU Member States on this law.

I hope my testimony to you today will inform you of how Europe's approach may be complementary to or even mirror your own efforts to modernize such laws in the USA

I fully understand and respect the need for each trading bloc to establish its own sovereign rules and practices and therefore, wish the committee every success in its deliberations. I completely understand what a tremendous responsibility you have as legislators, and believe me when I say "I have been there". I also recognize that we are, broadly speaking, dealing with the same questions and therefore have the similar difficult tasks in reconciling issues in our multi-jurisdictional regions or states.

As to cooperation between the European Union and the United States, I wish to point out that the principle of "recognition of equivalence" of our respective regulatory regimes does not imply for the rules and principles to be the same, but rather to be recognized as similar in terms of their effect and outcome.

Instead of taking divergent approaches, the impact of the near-meltdown of the financial services sector means that politicians across the Atlantic and around the globe have to agree to common approaches and regulatory structures. I am pleased that we have been able to collaborate effectively so far, and hope that we can continue to do so.

Systemic risk and the insurance industry

The insurance industry largely concerns the spread of risk and the determination to manage such risk. As a result, Europe is aiming at a harmonized/uniform understanding of what constitutes risks as well as how to manage it in a similar way across all EU 27 member states. Although there are different products across Europe, the member states are all expected to apply the same rules and tests to those products.

It is the management of risk that is important here for the EU. The chain of events which leads to systemic risk begins with the failure of management and supervision of the risks. The EU's focus has been to try to eliminate any failure by predicting behavior using reasonable models and testing against them. Whilst it is difficult to predict outcomes with exact certainty, the size of an organization may cause more difficulty than anything else.

On the institutional set-up for identifying and managing systemic risk in Europe, a Committee of so-called “Wise Men” led by Jacques De Larosière, former Managing Director of the International Monetary Fund, have proposed sweeping changes to the way European financial services are regulated. These proposals have been endorsed by the European Commission in its recent communication on European financial supervision.

If implemented, these changes would result in the creation of a European Systemic Risk Council, a new independent body responsible for safeguarding financial stability and conducting macro-prudential supervision at the European level. The European Systemic Risk Council would:

a) collect and analyse all information relevant for monitoring and assessing potential threats to financial stability that arise from the macro-economic developments and developments within the financial system as a whole;

b) identify and prioritise such risks;

c) issue warnings where risks appear to be significant;

d) where necessary give recommendations on the measures to be taken in reaction to the risks identified;

e) monitor the required follow-up to warnings and recommendations; and

f) liaise effectively with the IMF, the Financial Stability Board and other third country counterparts

Whilst it is clear that the EU and USA regulatory structures differ, experience of the financial crisis has brought to light important failures and gaps in the financial supervisory framework of both jurisdictions, in particular with respect to macro-prudential supervision. For this reason, I believe there is a good case to be made for a body such as the European Systemic Risk Council to be created in the EU. This model might be useful for the USA to consider in its current deliberations on what changes need to be made to its regulatory system.

How Europe gets information about the insurance industry

There are 27 regulators representing each of the Member States of the EU and these individuals meet under the umbrella of CEIOPS. Although CEIOPS reports regularly to the Parliament and Member States, the EU still has challenges of multi-jurisdictional approaches and separate laws and rules governing the insurance industry as a whole. This is set to improve substantially with the implementation of Solvency II in 2012. The EU still needs to finalize the structure for a single supervisory authority. The European Parliament has called for a consistent approach and passed a non-binding report proposing just such an integrated financial supervisor with legal powers.

Cross border oversight holding companies and the call for integrated supervision

The EU is moving rapidly towards a *one-point-of-contact* system. The details of this system are in negotiation between EU Countries. This system was developed from the De Larosiere report and highlights a need for greater integrated supervision. The proposal is to bring together the work of the three committees, the Committee of European Securities Regulators (CESR), CEIOPS, and the Committee of European Banking Supervisors (CEBS), dealing with EU oversight of financial sector regulation. It is not yet decided whether these bodies will work as a single integrated supervisor or will have legally binding powers. The work on day -to-day supervision will be handled by a collegially based system, so those countries with a cross border enterprise will all be responsible for its supervision with the mainstay of its core Group activities being supervised by the home supervising country. For example, a UK- based company will be licensed and its core group activities will supervised out of the UK even if it does business in 20 other countries. The UK Financial Services Authority (FSA) therefore will be the "lead supervisor" or otherwise known as the "group supervisor".

On Holding companies the approach of the EU has been to pursue a specific Law governing these enterprises as they offer a multiple of differing problems for single regulators in specific industrial sectors such as insurance.

Current legislation in this field is the Financial Conglomerates Directive which is subject to imminent review. Again the nature of the integrated financial supervisor will have an impact on this area of supervision.

Developments abroad <u>will</u> have an effect in the U.S. insurance industry

The reality of recent experiences in the financial services sector worldwide can lead to no other conclusion than that our systems are very closely linked. We must do all we can to improve our financial services regulatory systems, working together as much as possible. As a result, insurance regulation must improve also. We must end the regulatory arbitrage which allows the choice to be in the hands of the industry and citizens of our countries without sufficient consumer protections.

Solvency II will radically overhaul the prudential regime for insurers in the EU. The objectives of Solvency II are to deepen integration of the EU insurance market, enhance policyholder protection, and improve the international competitiveness of EU insurers and reinsurers. Solvency II will not only apply to the European operations of foreign insurers, it will also require European supervisors to assess the group supervision applied at the level of the parent to insurance companies incorporated within the EU whose parent is outside the EU. If the group supervision applied to the parent is not equivalent to that required under EU law, then the supervisor will have to take other measures such as requiring the group to set up an EU holding company covering all of its EU insurance operations.

To ensure a consistent assessment of the equivalence of other jurisdictions' supervision, Solvency II provides the European Commission with the power to make binding equivalence decisions about individual third countries based on criteria agreed with the European Parliament. The Commission will also be given the power to make binding equivalence decisions about individual third country's reinsurance supervision based on criteria agreed with the European Parliament. Where a third country's reinsurance supervision has been found equivalent reinsurers from that jurisdiction will be treated in exactly the same manner as EU reinsurers, in particular, they will not be subject to collateral requirements. If no equivalence decision has been made it is up to Member States to determine the treatment of EU reinsurers in their territory. This could include introducing additional requirements such as requiring the posting of collateral.

International communications among regulators

The USA's state-based regulatory system makes the dialogue between the EU and USA much more complicated. The significant divergence in regulatory systems also makes it more difficult to resolve problems such as the perennial issue of the discriminatory collateral requirements applied by USA regulators to non-USA reinsurers.

Next year as work begins on third country equivalence in the context of Solvency II we will be faced with the same question we always face with the USA when discussing insurance. Who should we talk to? Who speaks for the United States as a whole on insurance matters? Since equivalence decisions will have to be made at country level, this fact alone will make it almost impossible to find the USA equivalent under Solvency II, unless changes are made to the current insurance regulatory framework in the USA.

Whilst it is the case that cooperation agreements can be signed between individual European countries and individual USA States, nothing can be agreed to that undermines the EU's Solvency II standards and rules, which have legal primacy over the laws of EU member states. This means that the equivalency approach required for regime recognition can only be concluded between the EU and the USA as a whole,

Maintaining standards and enforcing the rules

The European Commission ensures that European Directives are correctly transposed and implemented in Member States. CEIOPS' Financial Stability Committee runs a macro-prudential surveillance programme designed to monitor the interplay between (re)insurance and financial stability.

Added to this Group Supervision is the approach employed by the EU to allow for the cross-border groups to operate in the 27 Member states. As each group is licensed inside their own home Member State these groups are given an effective "passport" to trade in any Member state. Approval by one country is approval by all. Each Country in turn has to adhere strictly to the Solvency II regime.

As part of Solvency II we have introduced new rules on group supervision that will greatly improve the supervision of insurance groups within the EU as well as coordination and cooperation arrangements between Member State supervisors including requirements regarding exchange of information. Solvency II also includes new enhanced disclosure requirements for both supervisors and insurers that will greatly increase transparency regarding supervisory practice and the financial standing of insurance companies. CEIOPS will also be given an enhanced role in the new system in a number of specific areas related to the supervision of EU insurance groups (e.g. approval of internal models).

Systemic risk and insurance

During the current crisis the insurance companies that were most likely to cause or be affected by systemic risks were those involved in significant quasi-banking activities (e.g. bond insurers and AIG's financial products activities). Life and pensions businesses have suffered from the second order effects of the crisis, in particular the reduction in interest rates and the fall in asset values. Non-life activities have tended to suffer less, although the economic downturn will likely have some impact on premiums and claims.

The failure to use appropriate controls and manage the risk leads to the problem of systemic risk. Reliance on too narrow a set of assets or not charging the right premium for the business written could be two examples of poorly managed risk. There are business considerations but also ethical considerations and dependent on the view taken of appropriate incentives to write business supervisors' could intervene to ensure that solvency is maintained appropriately.

Europe's attitude to guarantee funds

Burden sharing by compensation schemes is a practice used in some member states, Germany and the UK for example. The EU is now about to consider whether burden sharing should be changed in line with recent negotiations between the European Parliament and the EU member states so as to allow group support across borders in times of stress.

As a result, and following the recent crisis, most commentators agree that more harmonisation is required and the Commission has indicated in its communication that it supports acceleration of work to build a comprehensive cross border framework to strengthen the EU's financial crisis management/resolution systems, including guarantee schemes and burden sharing.

Conclusion

If there's anyone who's been close to being in this Subcommittee's "shoes" as you wrestle with these issues, it is I. I hope the EU's experience – and my own experience – with these difficult and important issues will illuminate your own debates, and that my observations today will prove useful to you as you deal with these issues. I stand ready to be a resource to you in any way I can.

Thank you again for the opportunity to testify before you today. I look forward to your questions and our discussion.